

End-Use Monitoring of Defense Articles and Defense Services Commercial Exports FY 2006

This report describes actions taken by the Department of State during the past fiscal year to implement the “Blue Lantern” end-use monitoring program. The Blue Lantern program is established under Section 40A of the Arms Export Control Act (AECA) to monitor the end-use of commercially exported defense articles, services, and related technical data subject to licensing under Section 38 of the AECA. The Directorate of Defense Trade Controls, in the Bureau of Political-Military Affairs (PM/DDTC), Department of State, is responsible for administering the International Traffic in Arms Regulations (ITAR) that implement the AECA. DDTC’s functions include registration of manufacturers, brokers, and exporters, licensing of commercial defense trade, overseeing compliance with U.S. export regulations, supporting U.S. law enforcement agencies in criminal investigations and prosecutions of AECA violations, as well as the end-use monitoring of licensed transactions. The Blue Lantern program is managed within PM/DDTC by the Office of Defense Trade Controls Compliance’s (DTCC) Research and Analysis Division (RAD). Blue Lantern end-use monitoring entails pre-license or post-shipment checks undertaken to verify the legitimacy of a transaction and to provide “reasonable assurance that –

- i) the recipient is complying with the requirements imposed by the United States Government with respect to use, transfers, and security of the defense articles and defense services; and
- ii) such articles and services are being used for the purposes for which they are provided.”

DDTC is currently authorized a full-time complement of 80 State Department personnel, which is supplemented by 8 military officers, about 45 contract personnel, a DHS/Immigration and Customs Enforcement Senior Special Agent, and, for the first time this fiscal year, an FBI Supervisory Special Agent. DDTC’s operational budget for FY 2006, in addition to American salaries, was approximately \$9.4 million.

Overseas End-use Monitoring: The Blue Lantern Program

Initiated in September 1990 and written into law under Section 40A of the AECA in 1996 as the USG's first systematic end-use monitoring program, the Blue Lantern program has strengthened the effectiveness of U.S. export controls and has proven to be a useful instrument in: 1) deterring diversions to unauthorized end-users, 2) aiding the disruption of illicit supply networks used by governments under U.S. or international restrictions and sanctions and international criminal organizations, and 3) helping the Department to make informed licensing decisions and to ensure compliance with the AECA and the ITAR. End-use checks performed under the Blue Lantern program have significantly encouraged compliance with legal and regulatory requirements and have proven particularly effective in combating the global "gray arms" trade. "Gray arms" refers to the use of fraudulent export documentation or deliberate misrepresentation of the facts of a transaction to acquire defense articles through legitimate channels for re-transfer to unauthorized end-users. U.S. embassy personnel, or, in some instances, DDTC personnel, conduct Blue Lantern end-use checks overseas to verify the *bona fides* of unfamiliar foreign companies, to ensure delivery of licensed United States Munitions List (USML) commodities to proper end-users and confirm proper end-use, and to determine compliance with DDTC licensed agreements.

Last year, DDTC received and reviewed over 70,000 license applications and other export requests, most of them routine and legitimate. A small percentage of cases, however, may be subject to unauthorized or illicit activity. Blue Lantern checks are not conducted randomly, but are rather the result of a careful selection process to identify transactions that appear most at risk for diversion or misuse. License applications and other requests undergo review by licensing officers and compliance specialists, who check case details against established criteria for determining potential risks: unfamiliar foreign parties, unusual routing, overseas destinations with a history of illicit activity or weak export/customs controls, commodities not known to be in the inventory of the host country's armed forces and other indicators of concern. The information derived from Blue Lantern checks help DDTC licensing officers and compliance specialists to assess risks associated with the export of certain defense articles to various countries and regions, and provides significant insight into the reliability of companies and individuals involved in defense procurement overseas.¹

¹ Because Blue Lantern checks are selected based on potential risk and not a random sampling across all DDTC licenses, data on unfavorable checks should not be regarded as statistically representative of all license applications.

Blue Lantern End-Use Checks in FY 2006

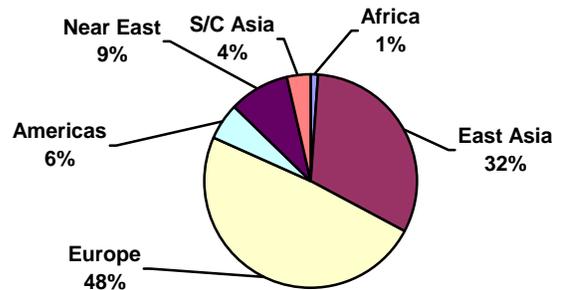
For the third year in a row, a record number of new Blue Lantern cases were initiated. In FY 2006, DDTC initiated 613 end-use checks: a nine percent increase over last year's 562 checks, but still only a small fraction – less than one percent – of the over 70,000 license applications or other export requests received during the fiscal year. Four hundred and eighty-nine Blue Lantern cases were closed in FY 2006, with 94 determined to be “unfavorable” – a rate of nineteen percent – and also a record.

The charts on the following page illustrate the regional distribution of all export requests compared to all Blue Lantern checks and to all unfavorable Blue Lantern checks.

Figures 1, 2, and 3:

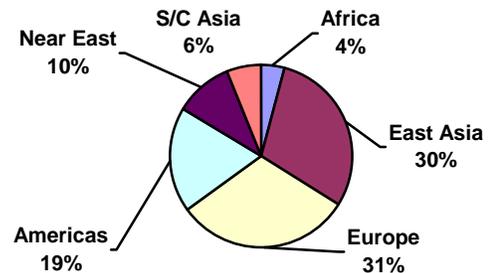
As illustrated in Figure 1, nearly 50% of all license applications were for exports to Europe, followed by East Asia, far behind with 32%.

Total License Applications by Region FY 2006



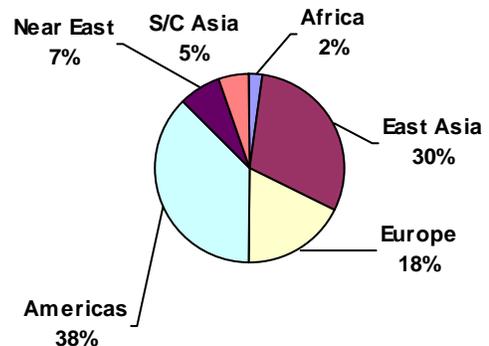
As Figure 2 illustrates, the regional breakdown of Blue Lantern checks does not necessarily match that of licenses. Europe has relatively fewer Blue Lantern checks (31%) proportionate to the number of licenses (49%), whereas the Americas – representing only 6% of export requests globally – were the site of 19% of Blue Lanterns.

Total Blue Lanterns by Region FY 2006



Unfavorable Blue Lantern results by region vary even further. Nearly 40% of unfavorable Blue Lantern cases were in the Americas – despite the fact that the region represents only 19% of all Blue Lanterns and only 6% of all licenses. Though not as dramatically, East Asia also represents a high number of unfavorable cases, whereas Europe is proportionally lower compared to its overall share of licenses.

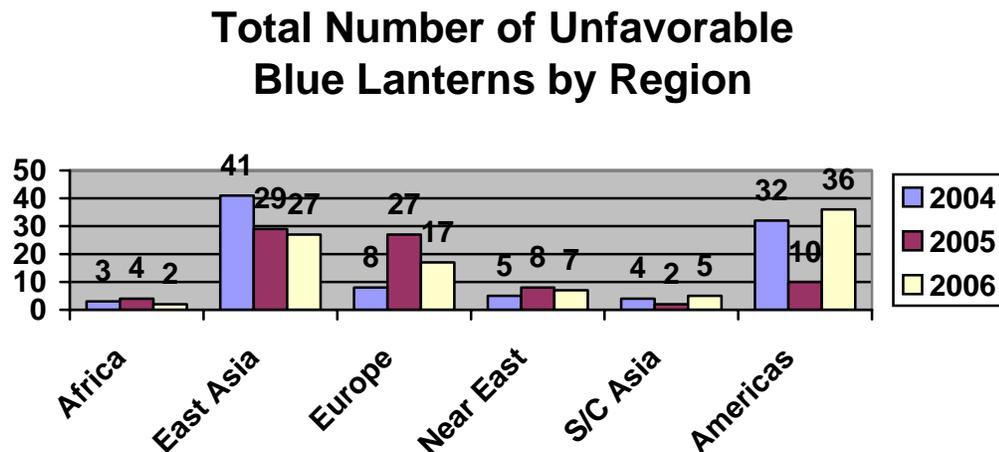
Total Unfavorable Blue Lanterns by Region FY 2006



Analysis of Unfavorable Checks by Region: FY 2004 - 2006

Over time, numbers of unfavorable Blue Lantern checks by region can fluctuate considerably. Despite a high number of unfavorable cases in the Americas (36) for FY 2006, last year's total for the same region was relatively low (10). Conversely, Europe dropped from twenty-seven unfavorable cases in FY 2005 to seventeen in FY 2006. East Asia maintained relatively high numbers of unfavorable cases over the past three years and the Near East, regionally the site of relatively low numbers of licenses, held fairly steady.

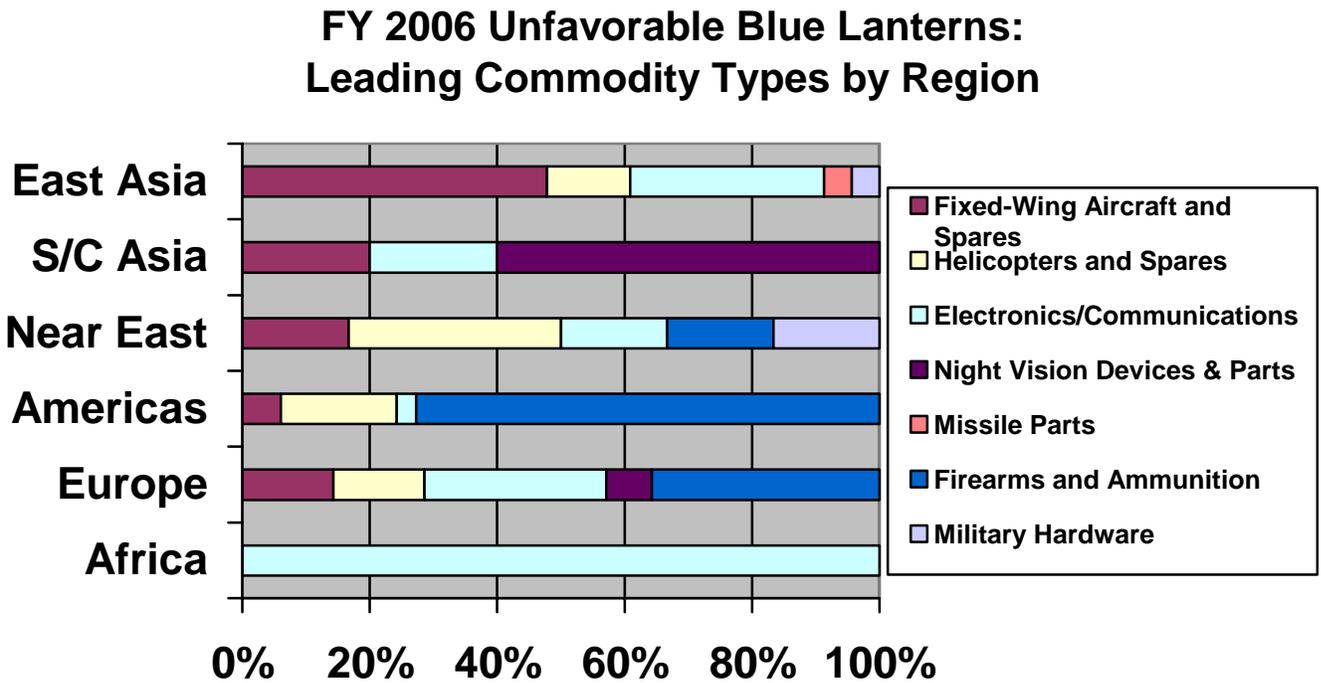
Figure 4



Analysis of Unfavorable Checks by Commodity and Region

The chart below (Figure 5) illustrates the types of commodities most often the subject of unfavorable Blue Lanterns by region. Of particular note is the very high incidence of unfavorable cases involving firearms and ammunition in the Americas (over 70% of all cases for the region). The high incidence of unfavorable checks involving firearms and ammunition in the region is a fairly regular pattern in recent years. Especially high numbers this year reflect increased scrutiny of unfamiliar importers in Central and South America, and several cases involving unauthorized brokers and dealers possibly illicitly re-exporting firearms. Also in keeping with an observable pattern over recent years are the high numbers of unfavorable Blue Lantern cases involving aircraft components and spares in East Asia. This trend appears to reflect a lack of understanding of ITAR controls by foreign intermediaries as well as likely attempts to re-export these commodities to embargoed countries such as China and Iran. The recent drop in unfavorable checks in Europe notwithstanding, annual results of the Blue Lantern program continue to demonstrate the presence of “gray market” activity in Europe and among other close U.S. allies and defense trade partners.

Figure 5



Reasons for Unfavorable Checks in FY 2006

- One or more parties deemed unreliable recipient of USML based on Blue Lantern check, or other derogatory information about parties uncovered: **37%**
- End-user reported that they did not order the items of the license – indicating possible intent on the part of the exporter or other parties to violate the ITAR and AECA: **19%**
- End-use different than that stated on the license: **18%**
- Parties not listed on the license involved in the transaction: **11%**
- One or more parties violated terms of an agreement or proviso on the license: **5%**
- Unable to contact/locate a party to license: **4%**
- Evidence of diversion or unauthorized re-export: **3%**
- Refusal to cooperate: **2%**

Blue Lantern Case Studies FY 2006

The following cases studies demonstrate some of the variety of problems that were found among this year's ninety-four unfavorable Blue Lanterns. In addition to representing different types of problems, many cases suggest that better due diligence on the part of the U.S. exporter could likely have prevented the problem from occurring. Better knowledge of foreign partners is critical to avoiding both routine problems and serious attempts at illicit diversion. As most of these cases were pre-license checks, they also exemplify the importance of careful scrutiny of license applications applied by experienced licensing and compliance officers. In cases where derogatory information was sufficient, investigative leads were passed on to law enforcement or intelligence authorities:

Case Study #1: Phony End-User/Consignee

Request for Permanent Export

Item/End-Use: Satellite components
End-User: Professor at a Southeast Asian university
Foreign Consignee: Unfamiliar Southeast Asian company

Reasons for Check

- Unfamiliar foreign consignee did not supply any supporting documentation from unfamiliar end-user
- Vague end-use statement

Findings

- No record of professor ever on faculty
- University specializes in medicine, has no satellite-related programs
- Application denied

NOTE: The same Southeast Asian company was listed on a separate export authorization request for radar components made by a different U.S. company. An additional Blue Lantern check found that the company was not listed in the public phone directory and that the number listed with a national trade bureau was for an unrelated private residence. The request was denied.

Lessons Learned

- Verify existence of end-user
- Confirm that commodity matches end-user's line of business
- Confirm existence of new foreign customers/end-users/consignees
- Conduct due diligence using public sources, including business directories, phone books, websites, etc.

Case Study #2: End-User Did Not Order Parts

Request for Permanent Export

Item: S-61 helicopter parts
End-user: Southeast Asian civil airline company
Foreign Consignee: Company in different Southeast Asian country

Reasons for Check

- End-user never listed on a State license
- Southeast Asian airline's public website did not list S-61 helos in its fleet
- No documentation from end-user

Findings

- End-user did not operate S-61 helicopters and never ordered the parts

Lesson Learned

- Verify that commodity matches end-user's needs and business practices

Case Study #3: Falsified End-Use Documentation

Request for Permanent Export

Item: Microwave filters
End-User: R&D entity in East Asia
Foreign Consignee: East Asian company
U.S. Applicant: Has done business with end-user in past

Reason for Check

- Suspicious-looking end-user statement that did not match previous documents submitted by end-user (misspelling in letterhead, no date, white-outs, no company seal or signature, etc.)

Findings

- Sole procurement officer for end-user did not place order
- Foreign consignee received order from a former employee of end-user who had been accused of corruption and suspended

Lesson Learned

- Scrutinize and authenticate end-use documentation

Case Study #4: Undeclared Consignee

Request for Permanent Export

Item: F-100 jet engine parts
End-User: South Asian Air Force
Foreign Consignee: South Asian company

Reason for Check

- Sensitive defense article

Findings

- Consignee provided purchase order and other end-use documentation
- Consignee intended to ship the parts to South Asian end-user via a private Middle Eastern company not listed on the application
- Middle Eastern company was on DDTC's Watchlist
- Application returned without action (RWA)

Lesson Learned

- Identify and know all parties involved in a transaction

Case Study #5: Unauthorized End-Use

Request for Permanent Export

Item/End-Use: Military computer components for use in meteorological system
End-User: Unfamiliar Eastern European company
Foreign Consignee: Familiar Eastern European company

Reason for Check

- Unfamiliar foreign end-user

Findings

- Foreign Consignee confirmed order from end-user
- End-user primarily engaged in nuclear systems integration, only recently expanded into meteorological systems
- End-user changed plans: intended to use components for nuclear power plant instead of meteorological system

Lesson Learned

- Ensure foreign parties understand end-use restrictions

Case Study #6: Expired Agreement

Manufacturing License Agreement (MLA)

Item: Aircraft braking systems
End-User: East Asian military
Foreign Consignee: East Asian defense company

Reason for Check

- U.S. company submitted voluntary disclosure: MLA had expired a year ago

Findings

- East Asian company refused to cease manufacture
- Blue Lantern *demarche* to East Asian government; manufacture halted
- DDTC determined that a new MLA was required
- Ceased production caused delays, interrupted “just-in-time delivery” for East Asian military

Lessons Learned

- Monitor/maintain agreements (parties, reports, expiration, provisos)
- Communicate terms/conditions of agreements to foreign parties

Case Study #7: Unauthorized Re-Transfer

Three Related Blue Lantern Checks

Items: Two helicopters
Original End-User: Middle Eastern military
Suspected Recipient of Re-Transfer: Latin American company

Reason for Check

- DDTC received information regarding an unauthorized retransfer of U.S.-origin helicopters purchased by a Middle Eastern country via the Foreign Military Sales program

Findings

- Middle Eastern military had sold the helicopters to a private Middle Eastern company
- The private company sold the helicopters to a private end-user in Latin America, which in turn re-sold them to a private bank in another Latin American country
- The helicopters were eventually located in the possession of a company owned by a suspected money-lauderer with alleged ties to paramilitary/terrorist groups
- Latin American authorities seized the helicopters

Lessons Learned

- Re-transfer authorization is essential to ensuring that USML does not fall into hands of illegitimate end-users
- Ensure *bona fides* of all foreign consignees and end-users involved in a transaction

Targeting: Increasing Focus on Agreements

Starting in 2004, and increasingly during FY 2006, the Blue Lantern program has sought to expand its traditional focus on DSP-5 (permanent exports of defense articles) licenses to include greater attention to licensed agreements. During FY 2006 eighteen Blue Lantern cases involved manufacturing license agreements (MLAs) (see case study #6 above), technical assistance agreements (TAAs), and warehouse and distribution agreements. Of these, five were found unfavorable. Whereas Blue Lantern checks on hardware exports allow the Department to check the bona fides of end-users and ascertain end-use of specific defense articles, Blue Lantern checks on agreements provide an opportunity to assure compliance with the provisions of these licensed agreements. As licensed agreements continue to grow as a proportion of defense trade cases overall, the Department anticipates continuing also to focus Blue Lantern efforts in this area.

Expanding Blue Lantern Outreach Overseas and to Industry

Compliance with U.S. defense export laws and regulations is dependent on well-informed partners in industry, both at home and abroad, and in foreign governments. During the past two years, Blue Lantern outreach teams have visited nineteen countries in Europe, East Asia, Latin America, and the Middle East for consultations with foreign government officials, foreign companies, and Embassy country teams to improve understanding of U.S. end-use monitoring efforts and export laws and regulations in general. These Blue Lantern visits have been measurably successful in resolving difficulties with conducting end-use checks in specific countries and in staving off potential problems by explaining the mission and goals of the Blue Lantern program. In addition to these bilateral consultations, Blue Lantern teams have made presentations on U.S. end-use monitoring programs at a June 2006 export control conference sponsored by the German government (attended by delegations from fifty-five countries), expert group meetings of the European Union and the Wassenaar Arrangement, and at a major export control conference this past Fall in Washington DC attended by over 600 U.S. and foreign defense industry representatives. These outreach efforts directed to overseas and defense industry audiences were in addition to regular briefings and consultations with the federal law enforcement and intelligence community on the Department's end-use monitoring activities.